DOW THEORY LETTERS INC.

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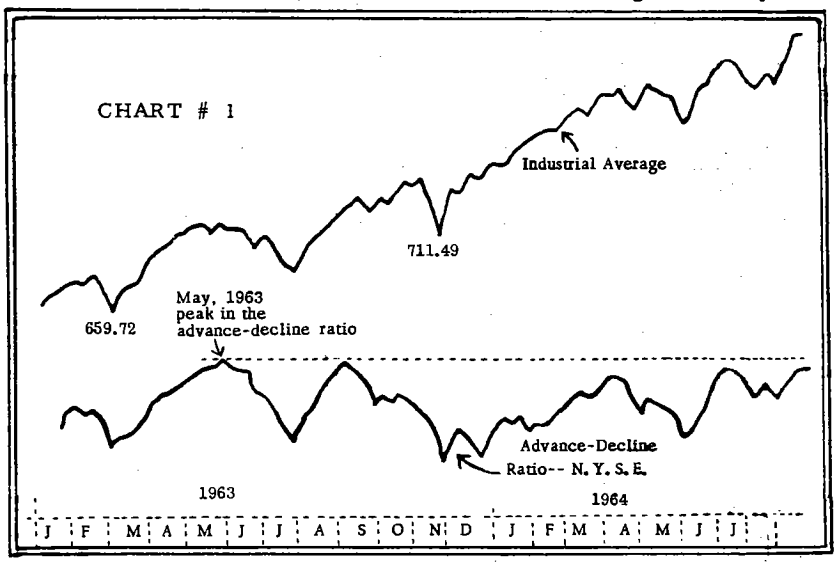
THE MARKET: Every veteran Dow Theorist is aware of what the Averages are "saying" on Chart 2. For here we note that Industrials established a high (July 17) of 851.35, while Rails struck a peak (also July 17) of 220.98. Following a decline on which Industrials persistently refused to confirm Rail weakness, a new rally started. On September 8, Industrials hurdled their July 17 point, and since then they have been recording a series of historic highs. Rails have (so far) failed to confirm by bettering their own July 17 peak of 220.98. The Averages are saying: "The trend continues in force (in this case up) until proved otherwise. Nevertheless, the lack of Rail confirmation is a factor worth watching carefully. Everything may be fine, and the Rails may confirm in due time — but until they do, be careful." While a nonconfirmation may be just an innocent "pause" preparatory to new highs, it can also be a prelude to danger. Almost every major decline in history has been prefaced by an extended divergence or an important nonconfirmation in the Averages.

Turning to Chart 1, we see a story which has been going on for 16 months. It might be termed a case of "height without breadth." For although the Industrial Average has climbed 145 points since the May, 1963, peak, the advance-decline ratio (representative of the advancing or declining tendencies of the majority of stocks on the N.Y.S.E.) has never bettered its 1963 high. In the past (see Letter 264) horizontal trading ranges in breadth have ultimately been resolved by major downside breaks (i.e., 1954, 1957, 1962). It may be different this time, but like the surgeon, the market analyst must rely on previous case histories to provide him with probabilities for the future. Sometimes the past parallels are pleasant and sometimes they are unpleasant. This writer doesn't make the history, however, he merely records it.



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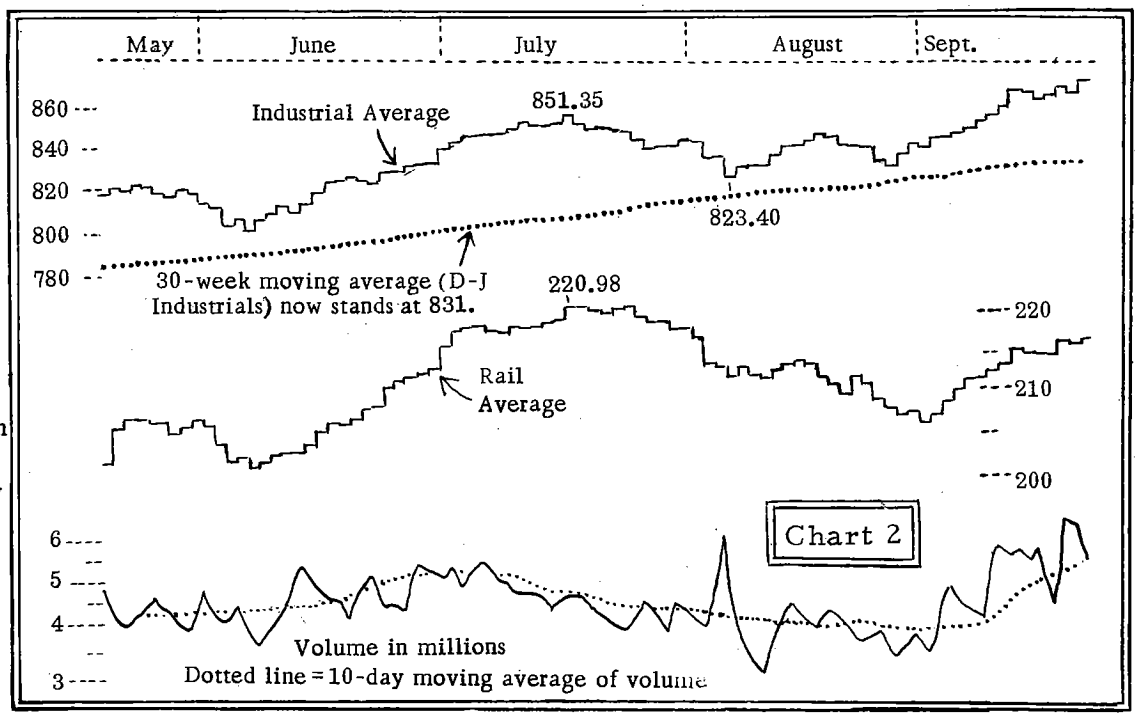
The following interesting and rather unusual situation has arisen. The D-J Industrial Average has now climbed 21 points above its July 17 high while neither the broad Standard & Poor 500 Stock Average nor the S & P 425 Industrial Average have bettered their own July 17 highs. This disparity is worth watching carefully (July 17 high for the S & P 425 was 89.05, July 17 peak for 500 was 84.01).

COMMENTS: As far back as Letter 188 (July 25, 1962) this writer called attention to the rising French fortunes. In a review of historical "contrary opinions," I stated the following view (which was then very much accepted): "The U.S. and Russia, the two great powers, are locked in in a 'death struggle' for world supremacy." I then offered my contrary opinion of what might occur: "The rise of Europe under the leadership of France and Germany as the third or even the leading power bloc in the world. A decline in



 importance of the U. S. -Russian struggle."

That guess seemed far-fetched then; it doesn't now. Make no mistake about it, DeGaulle sees France emerging as the leading power of the future. Already, the smirk that flickered across an American's or an Englishman's face when you mentioned DeGaulle and France has disappeared. Now it's DeGaulle and China, DeGaulle and the Common Market, DeGaulle and South America — but perhaps most important of all, it's DeGaulle and the power of gold.

Throughout history, leadership has gravitated to the nation that was accumulating gold. This was true of Spain, Holland, England, America, and now perhaps of France. Gold is a measure of a nation's economic power, discipline, and solvency. To have gold is to control the international purse strings.

At the recent International Monetary Fund meeting in Tokyo, France gave us a preview of her monetary strategy in her struggle for world leadership. The French presented a plan to put international currency transactions back on the gold standard! Distrusting the pound and the dollar (although they did not actually say so), the French want a third currency. This third currency (will it eventually be the franc?) would be created by a select group of nations, and the new currency would be linked to each nation's gold holdings (name of the new currency would be Composite Reserve Units). Settlement for transactions in the new currency would be made quarterly. Obviously, those nations in debtor positions such as Britain and the U. S. would systematically lose CRU's and gold while the stronger (solvent) nations would gain.

Sounds fantastic? Perhaps, but if the pound were to crumble, and if the dollar were to wobble, and if the franc were to hold strong, it would be interesting to see which nation the rest of the world would follow. As an added thought, it is a fact that the French are now converting their (U. S.) dollar holdings into gold at the rate of 30 tons a month or $400 million per year. Reason: France no longer wants to hold large amounts of dollar reserves (and at the same time she is setting a silent example for the rest of the world to follow). The foregoing is not a pleasant story, but it is part of what is occurring and I feel my subscribers should know about it.

NEW HIGHS AND LOWS: Much has been made this year of the weekly advance-decline ratio — while the "lagging" daily A-D ratio has been shelved by many analysts. This "transfer of allegience" undoubtedly results from the fact that the weekly A-D ratio has been rising to successive new highs — while the daily ratio has persistently refused to better its May, 1963, peak.

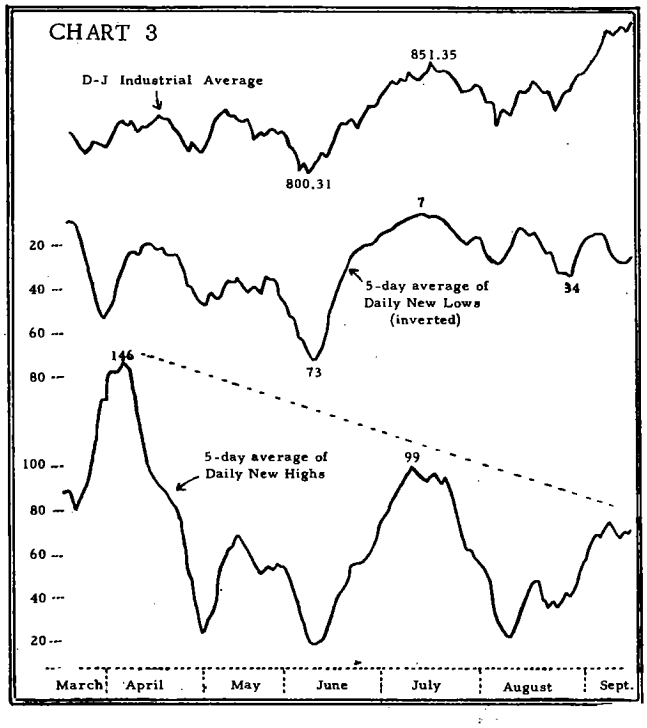
This writer has spoken to Mr. James Hughes of New York (Hughes is the man who originated the A-D ratio along with Colonel Ayres of the Cleveland Trust Co.) regarding this problem, and Hughes steadfastly insisted that reliable conclusions regarding breadth be confined to the daily ratio. The writer concurs.

The A-D ratio is supposed to reflect the total breadth picture. The mere fact that the weekly ratio is now at or near its high renders that indicator suspect. The implication of a new high on the weekly ratio is that the majority of stocks on the N. Y. S. E. are now at or close to their highs — and this is simply not the case.

On the other hand, the daily A-D ratio (Chart 1) makes the case for the majority of stocks being at or slightly below their May, 1963, levels, and after examining many hundreds of charts with this criterion in mind, I am inclined to agree that the daily ratio presents a truer picture of breadth than does the weekly.

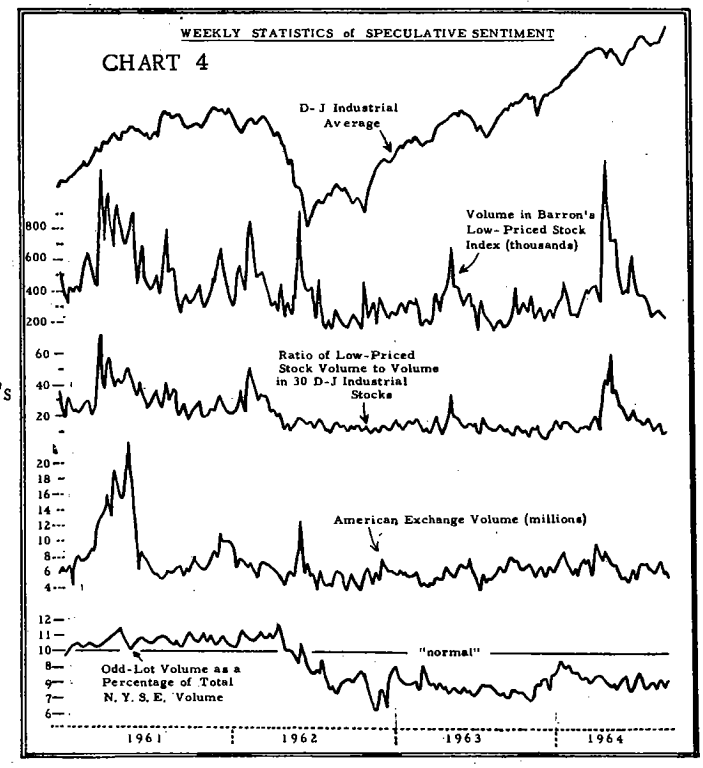
A different (but confirmatory) gauge of breadth is also worth discussing at this time. This is the index of daily new highs and lows. During a strong bull movement (at which time breadth is rising to new highs) it is normal for an increasing number of stocks to break out of their patterns and push to new highs. The greater the strength and breadth of the rise, the more stocks that can be expected to join the rising parade. One tool which readily measures this increasing strength is the statistic known as daily new highs.

Chart 3 shows the D-J Industrial Average superimposed upon a 5-day average of daily new lows (inverted) and a 5-day average of daily new highs. The highs and lows are presented in the form of 5-day averages merely to smooth out their movement and thus make their action easier to follow. The new lows are inverted so that they will confirm the new highs in direction (for instance, during a rise new highs tend to rise and new lows, inverted, will also rise).



Note on Chart 3 that the smallest number of new lows was 7 — recorded in mid-July. Since then, new lows have averaged between 20 to 35. By the same token, following the annual "switchover" to the new year's tabulation, the 5-day average of new highs reached a peak of 147 on April 7, 1964. Following a rapid contraction, the new highs next reached a peak of 99 in mid-July (corresponding to the contraction in new lows). As of this writing, the July peak in the 5-day average of new highs has not been surpassed. The ability or inability of this index to better the July mark will constitute an excellent gauge of market strength over the coming weeks.

SPECULATION: Chart 4 maps the progress of four key indicators of speculative sentiment. This chart appeared in Letter 227 and again in Letter 245. It has been brought up to date with this mailing.



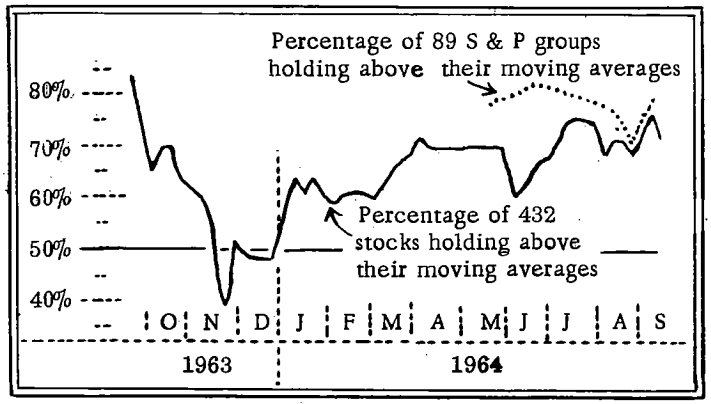
Note how dramatically all four of these indices expanded during the 1960-61 rise. Around mid-1961 the four indices "topped out," then sagged to low levels during 1962. Since 1962 the only real change in the four indices has been a sudden spurt (during mid-1964) in volume in Barron's Low-Priced Stock Index and in the Ratio of Low-Priced Stock Volume to Volume in the 30 D-J Industrials (see chart). But the mid-1964 flurry can be accounted for by the explosive action in Curtis Publishing, a stock (in Barron's L-P Index) which was recipient of some of the speculative fury generated by the Timmons mine discovery in Canada. It is significant, however, that neither Amex volume nor Odd-Lot Trading volume (see chart) were affected by the Curtis move. The mid-1964 action must therefore be dismissed as an isolated case of speculative intensity — not a trend.

What can we say of the rise which began in 1962? As far as speculative interest is concerned, it has been noticably absent from the entire advance. The four important measurements of "public excitement" shown on the chart suggest that the speculative waves which normally appear during an extended rise have not shown themselves on the rise (so far).

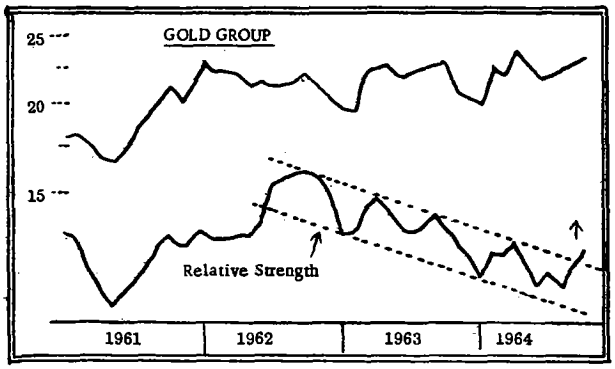
In view of this unusual situation, it might be well to ask ourselves how this advance will ultimately end. There are two important schools of thought on the subject. One group believes that the bull movement will simply fizzle one day — with no warning and without having exhibited classical signs of over-speculation. The second group believes that the rise will continue until the public finally jumps in and "takes the bait." This latter school puts forth the following argument: "The post-World War II bull market is the greatest bull market in history. It is bound to end with a mighty explosion in speculative sentiment — six, seven and eight million share days, a boom in low price stocks, more excitement than anything seen since 1929." To which the other group retorts: "We've already had that excitement; it occurred in three unprecedented waves — during 1958-59, during 1960-61 and during 1962-64."

STOCKS: Of 432 stocks tabulated here weekly, 207 (71%) are now holding above their 200-day (long-term) moving average (M. A.), a drop of 8% from the last reading (but the study remains bullish as long as the percentage is above 50%). No new reading this week on the 89 groups (see accompanying chart).

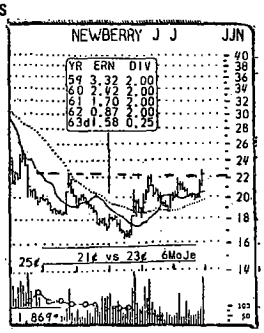
Investors and speculators usually pay too little attention to the performance of the group of which their particular stock selection is a member. When an entire group is strong, it usually means that whatever bullish factors are affecting the group will rub off to some extent on all the members of the group. Thus, a stock in a strong group has group popularity and the fundamentals of the group working for it. On the other hand, a single strong stock will sometimes emerge in a weak group, but purchasing such an issue carries with it the danger that (1) investors may not want to buy a good stock in a poor group, or (2) the weak fundamentals of the groups will ultimately work against the lone stalwart.

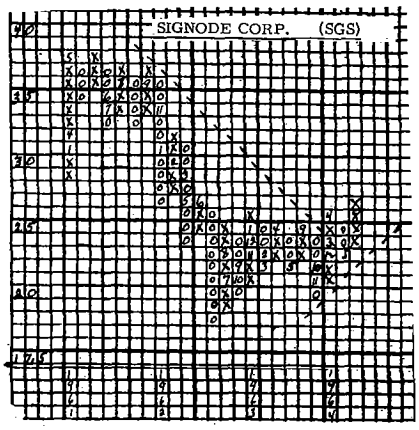


Thus, I now note that Richardson-Merrell looks quite good, but I hesitate to recommend it because the group as yet shows nothing. I note many recent service recommendations for International Paper, but the group relative strength (R. S.) is hitting new lows, which makes me worry about buying IP. Again, neither the Glass nor the Container groups look good, but Owens-Illinois looks fairly strong. However, I would rather leave it alone until the groups turn strong.



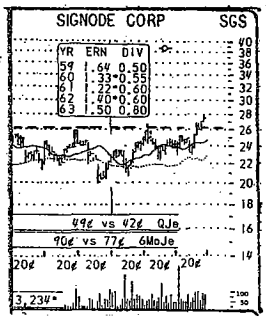
The British election comes up on October 15, and our election occurs in November. There will be much uncertainty between now and then, and some of that uncertainty (at least regarding monetary conditions) has been reflected in the recent spectacular run-up of the gold stocks (which were last recommended in Letters 263 and 265). Since those recommendations, American South African, Campbell Red Lake, Giant Yellowknife have all "broken out" and given "buy signals" as noted in the Letters. Dome's breakout point is 34 and the stock has come within a point of this level. New gold commitments should go into Campbell between 17-18 if possible. The chart above shows the definitive return to popularity of the Gold Group as the Group relative strength line reverses a two year declining channel.





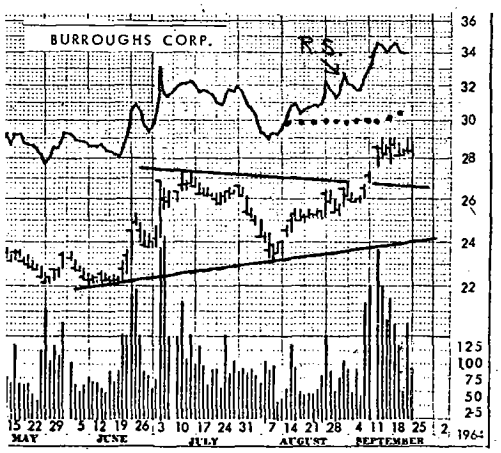
Any trading between now and election time will be increasingly risky. Nevertheless, I receive more mail regarding stock selection than any other single item. Clients insist that even if I don't wholeheartedly recommend stocks — I nevertheless discuss them.

Two issues which have beautiful base formations (believe it or not, technicians use the word "beautiful") are J. J. Newberry and Signode Corp. Newberry is a large retail variety chain, and as readers of Letter 264 know, the Retail Variety Chain Group is in the process of reversing a long downward trend in relative strength. There has been no insider or fund buying in Newberry, company showed a deficit last year, nobody loves JJN — but the chart pattern (see small weekly chart) is perfect and volume is coming in as the stock breaks out of a " head-and-shoulder reversal" pattern. Something bullish is going on here, and I list the stock as a speculative purchase.



Signode Corp. makes steel strapping and strapping equipment, and they have recently come up (with DuPont's help) with a new non-metalic strapping called Dymax. SGS, after a long decline from its 1961 high (see point & figure chart) formed an extended base, reversed its bearish trendline, and has now broken out at 27. The large base shows up dramatically on the small weekly bar-line chart. The base on the P & F chart is large enough to take SGS to the high 30's (but any such "count" or "objective" is, of course, always theoretical). SGS is a rather "off-beat" Big Board number, and I cannot discover any insider or fund buying here. The stock is in the Specialty Machinery Group, which touched a peak of R. S. in early 1961, hit a low in R. S. in early 1964, and could now be ready to return to market popularity. Signode is a very interesting speculation at this level.

Traders Research has come up with one of those rare innovations which really proves valuable in technical analysis. This is their "Performance Pattern" which is a 30-week moving average of the relative strength line. To illustrate, we see a daily chart of Burroughs. BGH has broken out of a triangle on volume, and the daily R. S. line (solid line) is now holding above the 30-week M. A. of the R. S. line (represented by the dotted line). As long as the R. S. line holds above the dotted line, the obvious implication is that BGH is continuing to act better than the market. More about this in forthcoming Letters.



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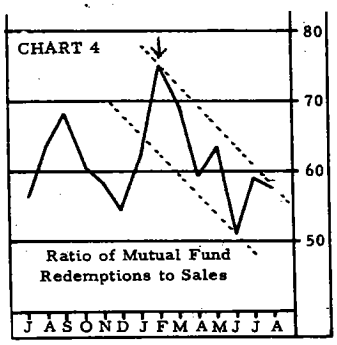
Charts of JJN and SGS courtesy of Quote Digest, 110 N. Lorraine, Wichita, Kansas.
P & F chart of SGS courtesy of Chartcraft, Larchmont, New York.
Chart of BGH courtesy of Traders Research, 1431 Pearl Ave., Alton, Illinois 62003.

This Letter completed Thursday, September 24, at 10 A.M.

although in 1961 the debit balances struck a peak simultaneously with the final high in the Industrial Average. An early topping of the debit balances also occurred in 1959 and in 1946, and during each of those periods the speculator (through his declining debit balances) gave warning of the major declines which were to come.

Here is a particularly important point: note that the action of the cash customer (credit balances) was different during 1962-64 than during 1957-59 and 1960-61. I have discussed this "different action" many times with Dr. Wilson, and he calls it the "post-crash syndrome." Observe that the cash customer sold during the 1962 crash (declining credits), bought heavily at the bottom (a huge jump in credits), then acted very erratically during the post crash period (1962-63). Finally, since January, 1964, the cash customer appears to have made up his mind, and credits have dropped steadily lower. This type of behavior was seen following previous crashes, and it is what makes for such difficult markets after severe crashes (for instance, following 1937 and 1946).

One other question: if the cash customer is not now plunging into speculative commitments on the N. Y. S. E. and the Amex (see Letter 266), where is he putting the cash which he is withdrawing from his brokerage account? The answer could be mutual funds. As an aid in clarifying this question, I have included Chart 4 (from Mr. Garfield Drew's well-known Odd-Lot Studies, 50 Congress St., Boston, Mass). This chart traces the ratio of mutual fund purchases and redemptions, and it tends to underscore the story being told by the declining credit balances.



On Chart 4 we see the persistent decline of the fund ratio (since February, 1964) towards increased mutual fund purchases and decreased fund redemptions. The number 50 on the chart signifies two fund shares purchased from every one redeemed, a very high rate of buying (and a figure almost approximated in June of this year). In July, 1964, public purchases of funds rose to around the highest level on record (although redemptions also increased). The trend shown on Chart 4 certainly suggests that the public is taking an increasingly bullish view of mutual funds (perhaps the crash shook the public's confidence in its ability to select stocks on an individual basis with the result that crowd bullishness is now directed increasingly toward the funds).

CONCLUSION: As Dr. Wilson recently observed: "It seems that the entire character of the market changed between November, 1963, and January, 1964. Margin accounts have been declining as the speculator decreases his commitments, and the public is picking up shares of stock at the same time." This type of action has always been associated with (1) an extremely "difficult" or highly selective market, (2) an approaching major top, although such a top could still be quite a few months away, and (3) a movement in which the Industrial Average joins with the already sinking credit and debit balances in a major decline.

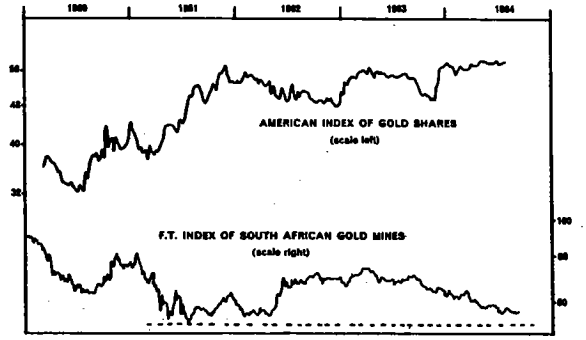
STOCKS: The graph of the percentage of 432 representative stocks and 89 groups holding above their moving averages has been incorporated in the composite Page 1 chart. Of the stocks, 73% are now holding above their moving averages, a figure still well above the critical 50% level.

The Gold stocks have ended their violent rise for the moment, but most of the gold issues are holding near their highs. They appear to be "resting" and waiting. One reason for gold interest can be seen from a single statistic. Under U. S. law, gold (certificates) may not drop below 25% of Federal Reserve Liabilities. Last week the ratio sank to 28.9%, lowest figure on record. If we approach (or drop below) the critical 25% ratio, something will have to be done — and quickly, or Federal Reserve Credit will undergo (involuntary) contraction. Washington knows it, and this is part of the reason for the frantic rounds of manipulations and exchange-agreements which are being reported almost weekly. With the gold ratio at an uncomfortable 28.9%, the U. S. cannot afford to lose very much more gold.

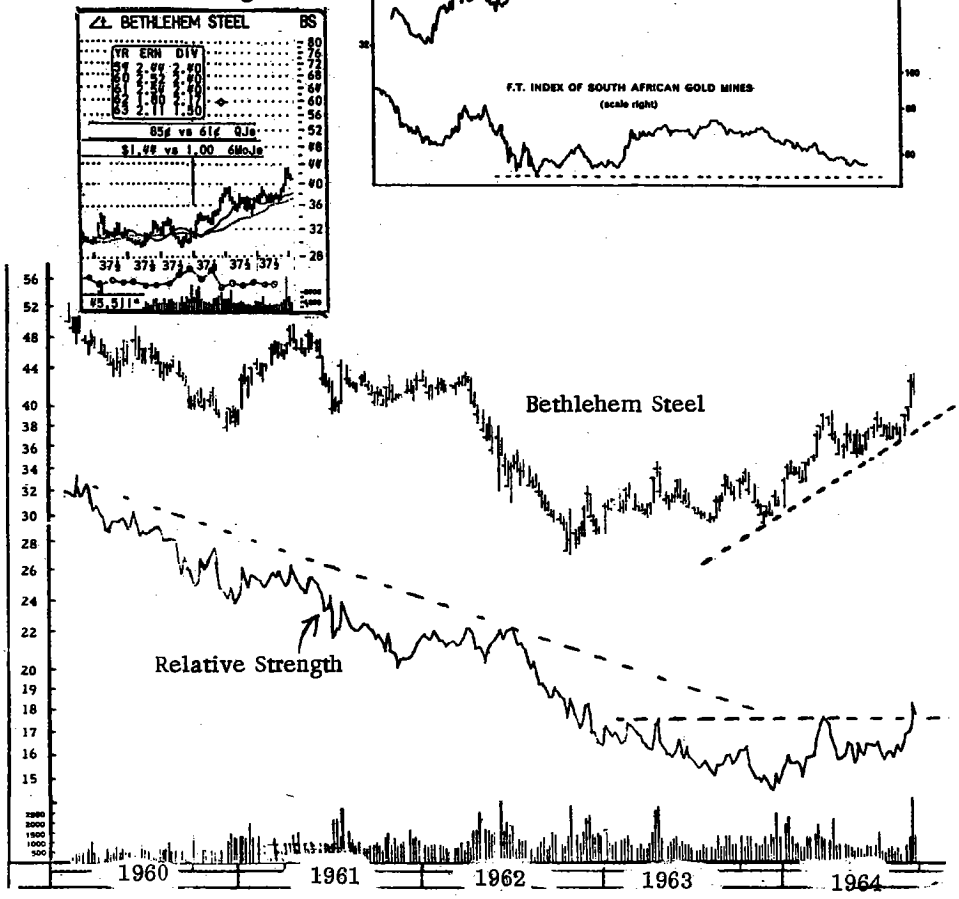
"Bunk!" retort the gold-detractors. "Why not simply remove the 25% gold clause and thereby free all our gold so that it can be used in its entirety for backing foreign claims. If Americans have faith in their money, they don't need any gold behind their dollars. The 25% gold clause is archaic." Removing the 25% gold clause would serve to eliminate the last restriction against continued Federal "monetization" of the debt (i.e., the act of printing dollars). Furthermore, the tide of international thinking is again running towards gold based currency (see discussion in last Letter). A removal of the last vestige of gold backing behind the dollar could therefore prove embarrassing at this time. Secondly, if the 25% gold clause is to be removed, it is generally conceded that it should be removed under conditions of strength — not weakness. So far, the long-promised strength has failed to materialize as far as the U. S. balance-of-payments are concerned.

I have received many inquiries about the world's richest gold mining shares, the South African Mines. The accompanying chart shows the long decline since 1962 in the S. African golds, a decline which has not been shared by American or Canadian Gold shares (as seen on the chart on page 4). Strangely, American-South African Investment Trust (listed on the N. Y. S. E.) recently touched a new high, although it holds largely S. African Gold mining equities. What is clear is this — investors are largely

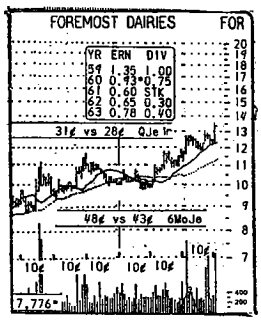
unwilling to hold S. African gold stocks because of the African racial problem. Nevertheless, the chart shows that the Index of S. African Gold Mines is now approaching the "double bottom" which was formed in 1961-62. This writer believes that that bottom will hold again.



If a market "blow-off" materializes, the Metals can usually be depended upon to be the late but spectacular climbers. Of the metal groups, the one which may have the best potential from here is the Steels. Some of the "heavy" Steel companies are still well below their highs of 1959 or 1961. Three of the giants are Republic, U. S. and Bethlehem. Of these three, there is no question but the Bethlehem acts best. Following the market low of 1962, Republic recorded its peak of relative strength (R. S.) in late-1962 while U. S. touched its peak R. S. in late-1963. BS alone is now hitting new highs in R. S. (see accompanying weekly chart). Furthermore, as seen on the chart a five-year trend of declining popularity (R. S.) has now been reversed by BS. BS was recommended in Letter 264 at 39. Since then the stock has run up to 43, and more recently settled back to the 41-42 area. I believe that Steels now are a good hedge on the upside. If Steels cannot move out from here, the market probably will not move out either. BS is "near enough the ground" so that if trouble comes, it should be relatively "sticky" on the downside (BS is always heavily traded and easy to sell). The last important trendline (see chart) on BS occurs at 37 1/2, and this level constitutes the "risk" as far as BS is concerned (see chart). For participation in any possible forthcoming "fireworks," I continue to recommend BS.



A low-priced stock which is acting well and could "catch on" is Foremost Dairies. The stock is considerably deflated, following FTC divestiture orders, and is now diversifying. Point & Figure chart shows a reversal of its declining trendline with a fairly good base. The stock (see small weekly chart) is holding well above its 10 and 30-week moving averages (funds bought 15 thousand shares of FOR over the last three months). An interesting speculation which is gathering consistently more volume on the N. Y. S. E.



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This Letter completed 11A.M., Tuesday, October 6.

Chart of BS courtesy of Traders Research, 1431 Pearl Ave., Alton, Illinois 62003.
P & F chart of FOR courtesy of Chartcraft, Larchmont, New York.
Small weekly chart of BS and FOR courtesy of Quote Digest, 110 N. Lorraine, Wichita, Kansas.

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NOTE: I just received the new informal report now being put out by my peripatetic friend, Mr. Harry Schultz. This gentleman is in touch with more market phenomena (he is constantly circling the globe) than any man I know, and he is particularly close to the world money situation. His new book (Prentice Hall) is now available at this office. It is called "Bear Markets" and of all the hundreds of stock market books published, this is only the second to contain the words "bear market" in its title (price for this large, fascinating and very informative book — $12.50). Those interested in Mr. Schultz's report can "catch" him at P. O. Box 4283, Inglewood, Calif.